The parallels between success in value investing and a well-balanced life

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SPECIAL TO THE GLOBE AND MAIL
PUBLISHED YESTERDAY
FOR SUBSCRIBERS

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Value investing is about stock picking – how to find and buy stocks that trade significantly below intrinsic value. By following a process that enables them to identify undervalued assets, a value investor wants to buy a stock that is worth $1 for 50 cents.

Value investors argue that prices diverge significantly from value in the short run. If they buy stocks that trade significantly below intrinsic value and patiently wait for markets to approach that mark, they will make money. It is human nature and conflicts of interest by professionals that move prices away from fundamentals in the short run.

A requirement, however, to make money is for stock prices to eventually reflect what their true value really is. That is, for stock markets to ultimately become efficient.

What is the value investing process I referred to above? It is a three-step process. First, value investors try to identify stocks that look like they are undervalued. Some value investors focus on obscure (small cap, low analyst following) and undesirable stocks (low price-to-earnings and/or price-to-book ratios), while others look for stocks that have barriers to entry and sustainability. This step enables them to reduce the sample of stocks they will examine in depth later and to make sure that their selections have desirable characteristics. Then, in the second step, they value these stocks to determine their intrinsic value. Finally, in the last step, they make a decision to buy only the stocks that are truly undervalued, that is, they meet a predetermined margin of safety.

So value investing is more than choosing stocks with a low P/E (or low price-to-book). Unfortunately, academic research has tended to focus only on stocks with low P/Es, which is only the first step of the value investing process, and this has created confusion in the public sphere about what value investing is, and whether the strategy is dead.

Value investing has evolved over time, even though the core principles are the same.

Ben Graham, the father of value investing, focused on assets for stocks that are obscure and undesirable. If something goes wrong, investors can always sell the assets, which are easy to see and understand. Warren Buffett focuses more on cash flows. It is easy for investors to understand future cash flows that the assets produce, particularly for companies with barriers and competitive advantage. No matter what, value investors would rather minimize risk than maximize returns. They adhere to Aristotle, in that “the aim of the wise is not to secure pleasure but to avoid pain.”

Value investing is not deterministic, like physics or math. It is not a science, but an art. Proper analysis and the right process are key. Experience and intuition are very important, too. One needs to follow a holistic approach, which means understanding: accounting (reading historical financial statements); finance (having an idea of how the future may unfold and how it will affect the financials of the company); economics (how markets are structured and the drivers of interest rates); strategy (barriers to entry, competitive situation, catalysts, sustainability, etc.); and psychology (weaknesses of human nature and institutional conflicts of interest).

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Having the right frame of mind in making decisions and the right character are of paramount importance if one wants to become a successful value investor – humility, patience, discipline and a long-term perspective are required.

Emotions, on the other hand, cloud one’s judgment and lead to illogical conclusions. Humans are not rational, they overact, are overoptimistic and herd, and such behaviour pushes stock prices away from value. Institutional behaviour also introduces biases in stock prices owing to the conflicts portfolio managers have when they manage other people’s money.

You can be the best valuator and the best screener, but if you panic, you get greedy and you are impatient, you will never be a good investor. And if you do not do your homework and you are not independent, you will never be a good value investor. No one is watching your back – that is your job. The best investors understand human nature and institutional biases.

What follows is some basic attributes for investing success.

Reasonable intelligence

- As Mr. Buffett says, investing is simple, but not easy.
- Understand human weaknesses and institutional biases.
- Be passionate about value investing.
- Have the right frame of mind about making decisions.

Sound principles of operations

- Understand businesses from the bottom up.
- Have a proper valuation model.
- Take a holistic approach to investing and understand accounting, finance, economics, strategy and psychology.
- Deal with simple companies and simple business structures.
- Understand the history of financial markets.
- Do one's homework, be independent, have long-term perspective.
- Put one's money in one's best ideas, that is, have a concentrated portfolio.

Sound character and temperament

- Never make an impulsive decision.
- Do not follow the crowd, be a contrarian.
- Have an analytical process in place of when to buy and when to sell; that will help you overcome your emotions.
- Have a checklist of what a stock needs to have to be attractive.
- Talk to a knowledgeable friend; mentors are important.

If one does all the above, one will not only do well as an investor, but also in life. Patience, discipline and long-term perspective are traits that define one's character and can help investors achieve not only investing success but also a balanced and full life.